KING IV
TAX
GOVERNANCE
In recent months, there has been immense media and public attention on whether multinational companies (MNCs) are paying their fair share of taxes in the countries where they generate their profits.

Reputable media outlets have splashed the tax affairs of many MNCs all over the media – highlighting the fact that these highly profitable organisations seem to pay very little or, at times, no corporate taxes in the jurisdictions in which they operate, by using legal but aggressive tax planning arrangements. While legal, these tax planning schemes can have a significant, negative effect on a company’s financial performance and its reputation as a good and ethical corporate citizen.

These developments have therefore placed the issue of tax corporate governance firmly in the spotlight and specifically the role which the board must play in guarding against aggressive tax planning strategies, and in upholding ethical business practices and good corporate citizenship.

Sound tax corporate governance is no longer a “nice to have” on a board. Instead, boards are increasingly being expected to include tax corporate governance on their agendas. Sadly however, today, the tax risks of organisations and its potentially negative impact are often still not sufficiently understood at board level, mainly due to its complexity, the lack of tax expertise among board members, and the lack of communication by the executive to the board on tax risk management issues.

The public outcry on the issue of profit-shifting by MNCs is further fuelled by the fact that often the countries who are at the receiving end of these aggressive tax avoidance schemes, desperately need to achieve economic growth. In the recent “Global Economic Prospects” report issued in January 2016 by the World Bank Group, it was noted that economic growth in sub-Saharan Africa decreased from 4.6% in 2014 to 3.4% in 2015. Thus, while sub-Saharan Africa is growing, we are not growing fast enough; more importantly, we are also not growing inclusively enough and as a result poverty and income inequality remain key challenges on the African continent’s agenda. To address these challenges, we need a buoyant revenue base and historically corporates have been one of the main contributors to the countries’ revenue coffers. However, if corporates, through the use of aggressive tax planning strategies end up making low, effective tax contributions to the tax coffers of the countries in which they generate their profits, then these countries cannot achieve their targeted economic growth rates. The debate therefore, rages on as to how governments can effectively combat the significant financial leakages from their economies which occur as a result of base erosion and profit-shifting by MNCs.

Against this backdrop, it was no surprise that the Draft King IV Report on Corporate Governance for South Africa 2016 (King IV) addressed this issue head on and specifically the role that the board needs to play in this regard. More broadly, King IV also shines the spotlight on the role of the board in Tax governance and notes that the board and the audit committee should be responsible for a tax strategy and policy that are compliant and congruent with corporate citizenship and wider stakeholder considerations and that in particular, the board should also take into account the reputational consequences of tax decisions to the organisation.

This article specifically focuses on the King IV proposals dealing with aggressive tax planning arrangements by MNCs and the role of the board in guarding against such practices.

Governing tax risks - Is your board ready, able and willing to govern?
In recent months, the low global, effective tax rates of a number of reputable MNCs have come under the spotlight. Closer to home, in South Africa, there is still a material gap between our nominal corporate tax rate of 28% and the effective tax rates paid by some MNCs.

That said, our tax legislation and case law also recognise the principle that every taxpayer is entitled to order its tax affairs in such a manner that it pays the least tax possible, provided it does so within the boundaries of the law. Importantly however, our tax law distinguishes between “normal” tax avoidance strategies (i.e. those which are done through legitimate tax planning) and “aggressive” tax avoidance strategies (i.e. those which exploit technical tax loopholes).

Unlike tax evasion which is illegal, aggressive tax planning schemes are legal, but it very much relies on, (and exploits) the grey areas of interpretation in tax law, in order to artificially reduce the organisation’s tax bill.

For example, the mismatches between the domestic tax laws in various countries and double taxation agreements can often be exploited by MNCs to artificially reduce its corporate tax liability on a global basis.

The question which thus arises is: If an MNC is able to significantly reduce its tax liability by optimally structuring its tax affairs, through legal, but aggressive tax arrangements, does this mean that the company’s board has not exercised proper oversight over its ethical business practices from a tax governance perspective or does it simply mean that the tax legislation governing MNCs is in need of drastic reform to effectively combat such practices?

It would seem that internationally, the answer is a combination of these two remedies. Governments and tax authorities across the globe have recognised that more needs to be done, both from a tax corporate governance and a tax technical reform perspective to address aggressive tax planning strategies.
INTERNATIONAL DEVELOPMENTS IN TAX CORPORATE GOVERNANCE

In South Africa, King IV has signalled that it is now becoming an imperative for tax risk management to be incorporated into the corporate governance framework of the board. More importantly, each board member (and not only the members of the audit committee or the risk committee) needs to have a good grasp of the organisation’s tax control framework and in particular, board members need to know whether any aggressive tax planning strategies have been implemented by the organisation. The latter should then be balanced against ethical business behavior and good corporate citizenship.

In the United Kingdom (UK), tax corporate governance by boards is also receiving attention. The UK tax authority released a discussion document during 2015 which inter alia sought consultation to implement a proposed legislative requirement that would require MNCs (with a certain turnover/balance sheet total threshold) to publish their tax strategy as it relates to, or affects UK taxation and inform the tax authority when it is published. The intention being that the strategy “should be formalised, articulated and owned by an executive board member within the business” from a board governance perspective.

The Australian Tax Office (ATO) also issued its tax risk management and governance review guide which among others, focuses on the board’s responsibility regarding the tax control framework in the organisation. The guide sets out various best practices which the board should apply when it comes to tax corporate governance.

The United States of America has also adopted various measures to improve tax corporate governance by boards and in New Zealand, the tax authority included tax governance as a criterion in its assessment of large enterprises’ risk ratings.
Over the last few years, many governments have collaborated to deal with the issue of base-erosion and profit-shifting by MNCs. These collaborations resulted in the release by the OECD of its 15-point action plan on Base-Erosion and Profit-Shifting (also known as BEPS).

BEPS represents the most far-reaching effort to date by governments in modern history, to reform the international tax system in order to combat aggressive tax planning. The primary goal of BEPS (which covers a wide range of international tax issues) is to ensure that there is alignment between the jurisdiction where the profits are taxed and the jurisdiction where the economic activity which generated the profits took place.

A very important aspect of BEPS which will have far-reaching consequences for MNCs and the boards which govern them, is the new country-by-country (CBC) reporting rules. These rules, when adopted by a country, will require MNCs to prepare a global financial blueprint of their operations in all the countries where they operate and do business. Such information must then be submitted to the tax authority of the ultimate parent company and various tax authorities may then exchange the information.

While at this stage, it is anticipated that these CBC reports will be confidential, there have already been calls for these reports to be made public and executive committees and boards need to be aware of this eventuality, and more importantly should prepare for it. These reports will contain significant amounts of information about the organisation. It will accordingly enable governments (including tax authorities) to thoroughly inspect and analyse the global operations of MNCs which operate in their countries and more importantly, to compare this operational analysis to the global tax footprint of the MNC – thereby checking if the MNC is paying its taxes in the countries where it earns its profits.

To date, the US and the UK have formally adopted CBC reporting and many other countries, including South Africa are also expected to adopt it. Specifically in SA, draft regulations were recently issued which indicate that the reporting period for MNE Groups commences for fiscal years on/after 1 January 2016. It is further anticipated that the first CBC reports will need to be filed with SARS as from 31 December 2017.

In addition, South Africa is also working with 93 other governments on a multilateral instrument that will enable preventative measures to be incorporated into our network of double taxation agreements to avoid treaty abuse. This will also include information sharing between the South African tax authority and foreign tax authorities.
QUESTIONS FOR DIRECTORS TO ASK

The time has thus come for board members to start challenging the executive on its tax risk management processes. Questions which could be posed in this regard, include the following:

1. Does the organisation have a tax corporate governance framework to deal with tax risks and if so, is it adequate and effective?

2. Is the board able to demonstrate that it has proper oversight over transactions in the organisation which may have significant tax implications?

3. What is the organisation’s Tax strategy and does it have a formalised Tax strategy document?

4. What is the organisation’s appetite for tax risk and is this aligned with the overall risk tolerance level of the group?

5. Has the organisation’s executive communicated to the board how the BEPS transfer pricing changes and specifically, the country-by-country reporting requirements will impact the organisation?

6. Is the executive monitoring and documenting BEPS-related activities of the organisation in all countries in which it operates?

7. Has the board discussed how the company should be preparing itself to deal with the changing landscape on BEPS? For example, is the organisation ready/preparing itself to be ready for the significant increase in the local and global reporting requirements which may be placed on it as a result of the local SARS transfer pricing documentary requirements and the country-by-country reporting requirements? Does the organisation have suitably skilled staff to deal with these requests and will information provided to the authorities withstand scrutiny?

8. Does the legal structure of the organisation and the income flow within that structure expose the organisation to tax risks and how are those risks mitigated? Will the organisation be able to withstand a SARS transfer pricing audit on its structure (e.g. what percentage of profit is allocated to low-tax jurisdictions, such as Mauritius, for example, and does the level of that profit reflect the real economic contributions in that jurisdiction)?

9. What processes are in place to assess the completeness of the tax risks (including transfer pricing tax risks) identified by the group and does the group have a tax risk register which lists both inherent and specific tax risks?

10. Are tax risks properly and timeously communicated to the Board?
As many countries start to adopt the new OECD approaches, global transparency and co-operation among governments are set to increase dramatically. Soon MNCs will have “nowhere to hide” and they will be under immense scrutiny of the tax authorities across all the jurisdictions in which they operate and will be called to account.

What is clear therefore is that, whereas historically, boards have generally always known that tax governance should be on their boards’ agenda but have left it to the CFO/FD to deal with, the time has now come for boards to ask the question: Are we governing tax risks in the organisation effectively for the benefit of all stakeholders? In this regard, as noted above, the board and its audit committee should ensure, in line with the King IV recommendation, that it takes responsibility for a tax strategy and policy that are both compliant and congruent with responsible corporate citizenship and wider stakeholder considerations, and importantly, that it takes account of the negative reputational repercussions where it neglects to do so.

The board indeed has a very powerful, yet extremely difficult role to play in the area of tax corporate governance and perhaps the most important aspect to remember is that every single transaction in an organisation has a tax decision attached to it and getting it wrong or being perceived to get it wrong, could have significant cash and reputational costs for the organisation.
For further information, visit the Deloitte Centre for Corporate Governance: http://www.corpgov.deloitte.co.za

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